

EXHIBIT D

No-Action Letter

Appln. No.: 10/092,005

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[Home](#) | [Previous Page](#)**U.S. Securities and Exchange Commission****No-Action Letter under:
Investment Company Act of 1940- Section 18(f), 22(d);
Rule 12b-1, 22c-1****ReFlow Fund, LLC**

July 15, 2002

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENTOur Ref. No. 2001619943
ReFlow Fund, LLC

By letter dated July 12, 2002, you request our assurance that we would not recommend enforcement action to the Commission under Section 18(f) or 22(d) of the Investment Company Act (the "1940 Act") or under Rule 12b-1 or 22c-1 thereunder against ReFlow, LLC ("ReFlow") or any registered open-end management investment company that participates in the program described in your letter ("Participating Funds").

Facts**Summary**

ReFlow is a newly organized, limited liability company that will rely on the exclusion from the definition of investment company pursuant to Section 3 (c)(1) or 3(c)(7) of the 1940 Act. As more fully described in your letter, ReFlow proposes to establish and operate an auction program over the Internet (the "Auction Program") through which it will make an alternative source of capital available to certain Participating Funds to allow them to satisfy some or all of their daily redemption requests. ReFlow expects a broad range of funds to participate in the Auction Program. In addition, ReFlow represents that all funds will be eligible to be Participating Funds, subject to certain criteria.¹

ReFlow will provide money to Participating Funds that submit successful bids in the auction by purchasing shares of the funds.² The next time that a Participating Fund in which ReFlow holds shares is in net sales, ReFlow automatically will request the fund to redeem the fund shares owned by ReFlow to the maximum extent possible without causing the fund to be in net redemptions, unless ReFlow notifies all Participating Funds prior to the Market Close that it has decided not to issue any redemption requests that Auction Day.³ You anticipate that ReFlow will rarely, if ever, exercise that option.⁴

You state that ReFlow will make the Auction Program available to eligible funds on an investment-blind basis, meaning that ReFlow stands ready to purchase and redeem shares of Participating Funds that submit successful

bids without regard to their investment objectives or performance, and that, consistent with the terms of the Auction Program, it will buy shares of Participating Funds that submit successful bids and redeem such shares without regard to their investment objectives or performance. Moreover, you state that neither ReFlow nor any fund can affect the outcome of an auction for a particular day after the Market Close for that day. Instead, you state that the selection of the successful funds and the computation of the respective dollar amounts of their shares to be purchased by ReFlow will be mechanically and automatically determined by operation of the Auction Program. You state that the timing and size of the redemption orders that will be placed with Participating Funds will be decided in the same manner, except in the unexpected case in which ReFlow decides on its own initiative to redeem shares of a Participating Fund.⁵

ReFlow's Purchase and Redemption of Fund Shares

ReFlow will operate the Auction Program each business day, provided that it has sufficient capital.⁶ At the beginning of each Auction Day,⁷ ReFlow will announce the terms of that day's auction on its web site, including how much money it initially has available, the minimum dollar amounts for which Participating Funds may bid and the lowest fee that ReFlow will accept from a fund bidding in the auction.⁸

A fund may bid for up to the dollar amount that it believes would reduce its anticipated net redemptions to zero as of the Market Close of the Auction Day. Alternatively, a fund may place a standing order with ReFlow that would automatically place a bid each Auction Day for a specified percentage of the fund's net redemptions on that day. In either case, the bid will include an offer to pay ReFlow a fee rate equal to a stated percentage of any money that the fund obtains in the auction. A fund may modify or cancel its bid, and ReFlow may cancel an auction, up until the Market Close for that day.

Each Auction Day, based on the fee rates bid and the information reported to ReFlow,⁹ the Auction Program will automatically determine the funds to which ReFlow will provide money, the amounts of money to be provided and the fee rate that will apply to all successful bids made that day. You state that the Auction Program will then automatically issue a purchase order to each successful fund at the NAV of the fund determined as of the Auction Day's Market Close. The Auction Program will not issue a purchase order to a Participating Fund for more than is needed to bring that fund's total net redemptions to zero.¹⁰

Also each Auction Day, ReFlow will automatically issue a redemption order to each Participating Fund in which ReFlow owns shares when the fund reports that it is in net sales, unless ReFlow has notified all Participating Funds before the Market Close that it has decided not to issue any redemption requests that Auction Day. The redemption order will be for the lesser of: (i) the net number of shares sold by the fund that Auction Day; and (ii) the number of shares owned by ReFlow that day, thus ensuring that ReFlow's automatic redemption requests generally will not cause a Participating Fund to be in net redemptions. You state that a Participating Fund will redeem shares held by ReFlow in the same manner that it will redeem shares held by other shareholders. ReFlow will add any money resulting from automatic redemptions (minus a small reserve for error

corrections) to the money available for auction that day.

Analysis

We address the various provisions under which you request no-action relief in the order in which you present them.

Rule 22c-1

Rule 22c-1 under the 1940 Act generally prohibits a registered investment company issuing any redeemable security from selling or redeeming any such security, "except at a price based on the current net asset value of such security which is next computed after receipt [of the order to purchase or redeem the security]." The Auction Program implicates Rule 22c-1 because ReFlow's purchase or redemption orders will be priced at the previously computed NAV of each Participating Fund that submits a successful bid; that is, ReFlow's purchase and redemption orders will be received by Participating Funds after the Market Close but will be priced at the NAVs calculated as of the Market Close.

The primary purpose of Rule 22c-1 is to eliminate or reduce any dilution of the value of outstanding redeemable securities of registered open-end investment companies that may occur through the practice of "backward pricing."¹¹ The rule also is intended to prevent speculative traders from engaging in short-term trades based on the knowledge that the value of an investment company's portfolio securities is not yet reflected in the fund's NAV.¹²

You acknowledge that Participating Funds may be engaging in backward pricing with respect to shares that they sell to or redeem for ReFlow through the Auction Program because ReFlow's purchase and redemption orders will be priced at each Participating Fund's previously computed NAV. You argue, however, that neither ReFlow nor a Participating Fund can take advantage of backward pricing to engage in the type of unfair or speculative trading that the Commission intended Rule 22c-1 to address.

You argue that ReFlow cannot take advantage of any backward pricing by a Participating Fund because, under the terms of the Auction Program, ReFlow has committed, in advance, to buying and redeeming shares of a Participating Fund under specific, objective circumstances and generally cannot exercise any discretion with regard to such purchases or redemptions.¹³ Based on the information reported to ReFlow each Auction Day, the Auction Program will dictate the funds to which ReFlow must provide money awarded through the auction, how much money ReFlow must allocate to each successful fund, and the number of shares that ReFlow must redeem of any Participating Fund that is in net sales as of the Market Close. You represent that ReFlow cannot influence the outcomes of purchases and redemptions made through the Auction Program after the Market Close.¹⁴

You also argue that a Participating Fund cannot engage in unfair or speculative trading through backward pricing because it cannot take advantage of a previously computed NAV. Each Participating Fund that is awarded money in an auction is committed to selling shares to ReFlow at its NAV per share as of that day's Market Close. Moreover, a Participating Fund

can affect neither the timing of ReFlow's redemption orders nor the number of shares to be redeemed.

Section 22(d)

Section 22(d) of the 1940 Act generally prohibits a registered open-end investment company from selling its redeemable shares at a price other than the current public offering price described in its prospectus. ReFlow's proposal implicates Section 22(d) because a fund's payment of a fee to ReFlow in connection with ReFlow's purchase of the fund's shares could be deemed to be a discount to the price of those shares. You argue, however, that the fee should not be viewed as a discount to the price of fund shares. Instead, you contend that the fee is payment for a *bona fide* service provided by ReFlow; that is, ReFlow will provide capital to funds under the terms of the Auction Program for the funds to use solely to satisfy shareholder redemption requests. In support of this position, you note that the board of directors of each Participating Fund must: (i) find that participation in the Auction Program is in the best interests of the fund and its shareholders; and (ii) authorize the fund to participate in the Auction Program so long as the fund promptly uses any money obtained through the Auction Program solely to satisfy shareholder redemption requests. You also argue that ReFlow will make the Auction Program available to all eligible funds on an investment-blind basis, meaning that ReFlow will not exercise any discretion in "deciding" whether or when to purchase or redeem Participating Fund shares. Instead, ReFlow will purchase or redeem fund shares automatically pursuant to the terms of the Auction Program.¹⁵

You note that we have issued no-action letters in which we agreed not to recommend enforcement action to the Commission under Section 22(d) with respect to the offer of certain discounted fees payable by a brokerage customer or investment advisory client for services provided by a distributor of fund shares or its affiliates when the customer or client purchased or held fund shares.¹⁶ Although you acknowledge that those letters are not directly on point,¹⁷ you argue that they are relevant because the underlying rationale is that the payment of a fee for a *bona fide* service should not be construed to be a discount from the purchase price of fund shares.

Section 18(f)

Section 18(f)(1) generally prohibits registered open-end investment companies from issuing senior securities other than with respect to bank borrowings. Section 18(g) defines "senior security," in pertinent part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." You argue that the shares of a Participating Fund purchased by ReFlow in an auction do not literally fall within the definition of "senior security" under Section 18(g). You further argue that such shares should not be deemed to be senior securities because the Auction Program does not implicate the concerns underlying Section 18(f).

Section 18(f) is intended to limit a fund's ability to leverage its portfolio through the issuance of senior securities and through borrowing.¹⁸ Leveraging "magnifies the potential for gain or loss on monies invested and,

therefore, results in an increase in the speculative character of an investment company's outstanding securities."¹² In addition, we have taken the position that any action by an issuer that results in material differences among the rights of its shareholders may create a senior security in violation of Section 18.²⁰

You argue that a fund's payment of a fee to ReFlow does not constitute special or preferential treatment of ReFlow. You reiterate that such a fee is payment for the *bona fide* service provided by ReFlow to that fund, i.e., providing capital on an investment-blind basis to the fund under the Auction Program. You note that the amount of the fee will not vary based on how long ReFlow holds a fund's shares. In addition, ReFlow will be treated like all other fund shareholders once it purchases shares of a fund through an auction, except that it will be obligated to redeem fund shares when the fund is in net sales,²¹ unless ReFlow notifies all Participating Funds prior to the Market Close that it has decided not to issue any redemption requests that Auction Day. Thus, you argue, shares sold to ReFlow are not senior securities under Section 18(g).

You also argue that the leveraging concerns of Section 18(f) are not implicated by the Auction Program. You argue that a Participating Fund's obligation to redeem the number of shares tendered by ReFlow is no different than the fund's obligation to redeem the shares of any tendering shareholder. In addition, you argue that a fund's participation in the Auction Program will not affect the fund's leverage generally. Moreover, you contend that the shares purchased by ReFlow do not represent a liability to the successful fund, as would a borrowing, but are more properly considered to represent the sale of an equity interest in the fund.

Rule 12b-1

Rule 12b-1 under the 1940 Act generally prohibits any fund from acting as a distributor of its own securities, except through an underwriter, unless the fund meets certain conditions set forth in the rule. For purposes of the rule, a fund is deemed to be acting as distributor of its securities if it "engages directly or indirectly in financing any activity which is *primarily intended to result in the sale of shares* issued by such company"²² The Auction Program may implicate Rule 12b-1 because a Participating Fund's payment of ReFlow's fee could be construed as financing the distribution of the fund's shares.

The Commission adopted Rule 12b-1 to permit funds to pay for the distribution of their shares under certain circumstances. The requirements of the rule are intended, in part, to address the conflicts that may exist between the interests of a fund and those of its investment adviser in deciding whether the fund should use its own assets to pay for the distribution of its shares.²³ You argue that a Participating Fund would participate in the Auction Program solely to obtain capital to satisfy shareholder redemption requests. You state that the fact that a Participating Fund's participation in the program may result in its sale of shares would be "merely incidental" to that legitimate purpose. In this connection, you note that each Participating Fund will provide ReFlow with a copy of a board resolution authorizing the fund to participate in the Auction Program so long as it promptly uses any money obtained through the program solely to satisfy shareholder redemption requests.

Further distinguishing a Participating Fund's payment of a fee to ReFlow from a payment for distribution of the fund's shares, you note that ReFlow will purchase and redeem the shares of all Participating Funds pursuant to the terms of the Auction Program.²⁴ ReFlow also will not act as a fund's agent in connection with the fund's sale of its shares. You also assert that the kinds of expenses traditionally paid pursuant to Rule 12b-1 plans (e.g., advertising; compensation of underwriters, dealers, and sales personnel; and the printing and mailing of sales literature) are qualitatively different from the fees to be paid by funds that receive money through the Auction Program.

Conclusion

Without necessarily agreeing with your analysis, we would not recommend enforcement action to the Commission under Section 18(f)²⁵ or 22(d)²⁶ of the 1940 Act or under Rule 12b-1²⁷ or 22c-1²⁸ thereunder against ReFlow or any Participating Fund. Our position is based upon the facts and representations set forth in your letter, particularly upon your representations that: (i) ReFlow will provide a *bona fide* service to Participating Funds through the Auction Program; (ii) ReFlow will make its capital available through the Auction Program on an investment-blind basis, as that term is used in this letter;²⁹ (iii) all funds will be eligible to be Participating Funds, subject to certain criteria;³⁰ and (iv) before participating in the Auction Program, the board of directors of a Participating Fund must find that the fund's participation in the Auction program is in the best interests of the fund and its shareholders. This response is being provided solely to ReFlow and Participating Funds, and may not be relied upon by any other party. Further, it expresses our views on enforcement action only and does not express any conclusions on the interpretive or other legal issues presented. You also should note that any different facts or representations may require a different conclusion.

We take this opportunity to provide additional guidance to Participating Funds. We believe that a Participating Fund should actively monitor its participation in the Auction Program. Among other things, the board of directors of a Participating Fund should consider periodically the fund's participation in the program, and terminate or suspend such participation if it finds that such participation is no longer in the best interests of the fund and its shareholders. We further believe that a Participating Fund should consider adopting and implementing procedures pursuant to which the fund would evaluate whether it is more appropriate under the circumstances to participate in an auction on a particular Auction Day or instead to borrow money or sell its portfolio securities to satisfy shareholder redemption requests. Such procedures should be reviewed by the fund's board of directors periodically, and modified, as necessary, to ensure their continued appropriateness under the circumstances.

Martin Kimel
Senior Counsel

Endnotes

¹ Under the Auction Program, every registered open-end management investment company ("fund") is eligible to become a Participating Fund, provided that: (i) it computes its net asset value ("NAV") as of the close of

business of the New York Stock Exchange, generally, 4 p.m. Eastern time (the "Market Close"); and (ii) ReFlow may invest in the fund without incurring a sales charge or transaction or redemption fee. ReFlow will, however, exclude a fund that: (i) is, or was during the preceding 12 months, subject to certain regulatory enforcement actions; or (ii) cannot represent that it is in compliance with certain legal and regulatory requirements applicable to open-end management investment companies.

Each Participating Fund must enter into an agreement with ReFlow that sets forth the terms of the Auction Program, including that the fund must: (i) notify ReFlow when it is in net sales, as that term is defined below; and (ii) provide ReFlow with a copy of a resolution from the fund's board (a) finding that the fund's participation in the Auction Program is in the best interests of the fund and its shareholders and (b) authorizing the fund to participate in the Auction Program so long as the fund promptly uses any money obtained through the Auction Program solely to satisfy shareholder redemption requests.

² A Participating Fund must be in "net redemptions" to obtain money in any particular auction. A fund is in net redemptions on any day when the number of shares subject to redemption requests exceeds the number of shares subject to purchase orders. Conversely, a fund is in "net sales" on any day when the number of shares subject to purchase orders exceeds that subject to redemption requests.

You state that a bid will have two components: one stating the fee rate bid by the fund and the other stating how much money the fund seeks from ReFlow to satisfy its redemption requests, expressed either in dollars or as a percentage of the fund's net redemptions that day. You represent that a fund that successfully bids for money will pay ReFlow only one fee per auction and that the amount of the fee will not vary based on how long ReFlow holds the fund's shares. You state that, in some cases, a fund's investment adviser or distributor may pay the fee. You request no assurances in connection with such payments, and we provide none. You also state that Participating Funds, their advisers and distributors will not pay any fees to ReFlow outside of the Auction Program.

³ You state that ReFlow also may adopt other automatic redemption procedures. You have requested no assurances in connection with any such other procedures, and we provide none.

⁴ See note 29, *infra*.

⁵ ReFlow is legally entitled to redeem fund shares in the same manner as any fund shareholder (*i.e.*, on its own initiative), but does not expect to redeem shares of Participating Funds other than through the automatic operation of the Auction Program. See note 29, *infra*.

⁶ You state that ReFlow may purchase and redeem shares of funds that do not participate in the Auction Program, but that such transactions will be effected outside of the Auction Program. You further state that ReFlow will not purchase shares of any fund that has entered into an agreement to participate in the Auction Program other than through the Auction Program.

⁷ For purposes of this letter, an Auction Day generally begins at 9:30 a.m. Eastern time each business day and ends at 9:30 a.m. the next business day. See note 9, *infra*.

⁸ You state that the amount of available money on an Auction Day may change during the day, depending upon whether and to what extent ReFlow automatically redeems shares of Participating Funds that are in net sales as of the Auction Day's Market Close.

⁹ Before the end of every Auction Day, each Participating Fund that is bidding for money that day, and each Participating Fund in which ReFlow holds shares, must report its: (i) net number of fund shares purchased or redeemed; (ii) NAV as of the prior Market Close; and (iii) number of shares of outstanding voting securities. You state that funds have until the end of the Auction Day to report information to ReFlow because they may not have final numbers to report at the Market Close. You state that ReFlow has determined to end each Auction Day generally at 9:30 a.m. the business day following the Market Close to accommodate funds that may not complete their accounting for an Auction Day until that time. You further state that the reporting deadline may be later than 9:30 a.m., but no later than 10:30 a.m., if ReFlow provides notice of the changed deadline on its website by the prior Market Close.

¹⁰ ReFlow also will not buy shares of any Participating Fund such that it would own more than three percent of the fund's outstanding voting securities after the purchase. See Section 12(d)(1) of the 1940 Act.

¹¹ Backward pricing occurs when a registered investment company sells or redeems its shares at a price based upon a previously determined NAV. See American Express Travel Related Services Company, Inc. (pub. avail. Nov. 24, 2000). See also Investment Company Act Release No. 5413 (June 25, 1968) (proposing Rule 22c-1); Investment Company Act Release No. 5519 (Oct. 16, 1968) (adopting Rule 22c-1) ("Rule 22c-1 Adopting Release").

¹² Rule 22c-1 Adopting Release; Charles Schwab & Co., Inc. (pub. avail. July 7, 1997) ("In adopting Rule 22c-1, the Commission expressed the view that backward pricing could permit a speculator to take advantage of fluctuations in the prices of the fund's portfolio securities that occurred after the fund had last calculated its NAV.").

¹³ As noted above, ReFlow may, before the Market Close, determine to redeem shares of Participating Funds on its own initiative or announce that it will not issue any redemption requests that Auction Day. See note 29, *infra*. See also note 3, *supra*.

¹⁴ You argue that the automated purchase and automatic redemption of shares by ReFlow is similar to the automatic share-exchange program described in Capital Preservation Fund, Inc. (pub. avail. Sept. 11, 1990). Under that program, shareholders were able to place standing orders to: (i) redeem shares of a money market fund and use the proceeds to buy fund shares in a non-money market when the latter's NAV fell below thresholds pre-determined by the shareholders; and (ii) redeem shares of a non-money market fund when its NAV rose above thresholds pre-determined by shareholders and use the proceeds to buy shares of the money market

fund. Whether a shareholder would have an automatic transaction effected on a given day would not be known until after the non-money market fund computed its NAV at or after the close of trading. In addition, if a trade was effected after the market's close that day, the shareholder would receive the previously computed NAV for shares of the non-money market fund. Without expressing any legal conclusions on the issues presented, we agreed that we would not recommend enforcement action to the Commission against Capital Preservation Fund and its fund family under Rule 22c-1 based on the facts and representations made by Capital Preservation.

¹⁵ See note 13, *supra*.

¹⁶ See Portico Funds, Inc. (pub. avail. April 11, 1996) (we agreed not to recommend enforcement action to the Commission under Section 22(d) in connection with a program that offered benefits to banking customers who also had invested in a fund affiliated with the customers' banks). In Portico Funds, we noted that we had taken the same position when: (i) the discounted transaction was separate from the purchase of fund shares; or (ii) the discount represented a reduction in a *bona fide* fee otherwise payable by the customer/investor for services rendered. See also Coleman Financial Services (pub. avail. April 17, 1987) (we agreed not to recommend enforcement action to the Commission under Section 22(d) against a broker-dealer that proposed to offer discounts on its commissions for selling non-mutual fund securities when the proceeds of the sales would be invested in mutual funds); American Municipal Securities (pub. avail. June 28, 1988) (we agreed not to recommend enforcement action to the Commission under Section 22(d) against a broker-dealer that proposed to offer discounts on its commissions for selling non-mutual fund securities when the proceeds of the sales would be invested in registered investment companies and/or bonds).

¹⁷ For example, unlike in Portico Funds, the transaction in which ReFlow would receive a fee from the fund, its adviser or distributor is not separate from the purchase of fund shares.

¹⁸ See Investment Company Release No. 10666 (April 18, 1979) ("Securities Trading Practices of Registered Investment Companies") ("Release IC-10666"). See also DataConcepts Fund, Inc. (pub. avail. Aug. 25, 1980) (citing Release IC-10666 and Section 1(b) of the 1940 Act, which section states policy against "excessive borrowing" by funds).

¹⁹ Release IC-10666.

²⁰ See, e.g., NEA Mutual Fund, Inc. (pub. avail. Feb. 16, 1974) (mandatory reinvestment of dividends for persons owning fewer than 100 fund shares is discriminatory and constitutes a class of senior securities). Accord United Services Fund (pub. avail. April 1, 1988) (citing NEA Mutual Fund).

²¹ See note 3, *supra*.

²² Rule 12b-1 (emphasis added).

²³ See Investment Company Act Release No. 11414 (Oct. 28, 1980)

(adopting Rule 12b-1).

²⁴ See note 5, *supra*.

²⁵ Our position under Section 18(f) is based in particular on your representations that no Participating Fund will provide ReFlow with any special or preferential treatment and that the amount of ReFlow's fee will not vary based on how long ReFlow holds the fund's shares.

²⁶ Our position under Section 22(d) is based in particular on your representations that:

(i) all funds will be eligible to be Participating Funds, subject to certain criteria (see note 1, *supra*); (ii) the board of directors of each Participating Fund must find that participation in the Auction Program is in the best interests of the fund and its shareholders; and (iii) ReFlow will automatically redeem shares of each Participating Fund that is in net sales that Auction Day, unless ReFlow has provided notice to all Participating Funds before the Market Close that it has decided not to issue any redemption requests that Auction Day.

²⁷ Our position under Rule 12b-1 is based in particular on your representation that ReFlow will not permit any fund to participate in an auction until it has provided ReFlow with a copy of a board resolution authorizing the fund to participate in the Auction Program so long as it promptly uses any money obtained through the Auction Program solely to satisfy shareholder redemption requests.

²⁸ Our position under Rule 22c-1 is based in particular on your representation that ReFlow cannot influence the outcome of the Auction Program's automated purchase and redemption determinations after the Market Close.

²⁹ We note that our position would not apply to any redemptions of shares of Participating Funds, or decisions not to redeem such shares, by ReFlow that are inconsistent with the investment-blind nature of the Auction Program.

³⁰ See note 1, *supra*. We note that we may have reached a different conclusion if the eligibility criteria of the Auction Program were such that, as a practical matter, only a select group of funds would be eligible to be Participating Funds.

Incoming Letter

July 12, 2002

Via Hand Delivery

Douglas J. Scheidt
Associate Director
Office of Associate Director (Chief Counsel)

Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, NW — Mail Stop 5-6
Washington, D.C. 20549-0506

Re: ReFlow Fund, LLC

Dear Mr. Scheidt:

We request, on behalf of the ReFlow Fund, LLC ("ReFlow") and any and all registered open-end management investment companies ("mutual funds") which engage in the auction process described below, that the Staff of the Division of Investment Management of the Securities and Exchange Commission (the "Commission") advise us that it would not recommend that the Commission take any enforcement action for violations of Rule 22c-1 and Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"), and Sections 22(d) and 18(f) of the Act if ReFlow and the other mutual funds described below were to participate in the proposed Dutch Share Auction Program ("Auction Program") as described below.

In short, we believe that the Auction Program proposed by ReFlow, under the circumstances and conditions described below, does not involve any of the abuses to which Rule 22c-1 was directed and will operate in a manner that should not result in violations of the Rule. We also believe that there is nothing in the text or underlying policies of Sections 22(d), 18(f), or Rule 12b-1 which would make the proposed Auction Program unlawful and that neither section should be interpreted to cause the Auction Program to be in violation of those sections.

Background

ReFlow is organized as a Delaware limited liability company. It is newly formed and has not yet conducted any business, other than developmental activity intended to position it to carry out its business purpose. Because ReFlow will hold shares of registered investment companies, it intends to operate as a Section 3(c)(1) or 3(c)(7) company.

The underlying business premise for ReFlow, and the basis for the decision of any mutual fund to participate in the Auction Program, is the fact that open-end investment companies pay a price for liquidity, that is, they bear additional costs due to the statutory obligation imposed on them to stand ready to redeem their shares on a daily basis. This cost of daily liquidity is tangible -- it can be measured for any particular fund depending on the fund's investment policies, composition of its portfolio, and history of daily purchase and redemption activity. For a number of reasons, offering mutual fund shareholders the right to redeem their shares at net asset value on a daily basis produces lower investment returns. Mutual funds may hold a certain amount of cash to be available to meet redemptions, but this money is generally not invested in accordance with the fund's primary investment objectives and, therefore, does not realize the returns that other invested assets may earn. A fund may also borrow to pay redemption proceeds to redeeming shareholders, but this involves the financing costs of borrowing. The fund may, of course, also sell its portfolio securities. This option is likely to involve brokerage and trading costs; it may force the sale of

securities at inopportune times; and it may cause the fund to realize capital gains, which may have adverse tax consequences for both redeeming and non-redeeming shareholders.

Through the Auction Program, ReFlow seeks to provide mutual funds with an alternative source of liquidity by means of a facility through which ReFlow would purchase at net asset value shares of participating mutual funds, enabling a participating fund to offset in whole or in part its net redemptions. When the fund next experiences positive sales, ReFlow would automatically redeem its shares in an amount equal to the lesser of: 1) the net number of shares sold by the fund; or 2) the number of shares owned by ReFlow.¹ Any fund participating in the Auction Program that is a successful bidder in the auction would pay a fee to ReFlow for offering this service.

ReFlow will require each fund that participates in the Auction Program ("Participating Funds") to enter into a contract with ReFlow that will set forth the terms and conditions of the Auction Program. The contract will require Participating Funds to obtain prior authorization from the fund's board of directors/trustees to participate, and to certify that fact to ReFlow. Any board of directors or trustees that has approved a fund's participation in the Auction Program would be required to find that the fund's participation in the Program is in the best interests of the fund and its shareholders, *e.g.*, that the cost to the fund (or to the fund's manager) of participating in the Program would be a beneficial expense compared to the portfolio transaction costs or borrowing costs that would be incurred if the fund were forced to sell securities or borrow money to pay the proceeds of redemption. The contract will require each Participating Fund to provide ReFlow with a copy of a resolution of its board of directors' finding that the fund's participation in the Auction Program is in the best interests of the fund, and authorizing the fund to participate in the Auction Program only so long as the fund promptly uses any proceeds obtained from the Auction Program solely for redemption purposes.

ReFlow will make the Auction Program available to eligible funds on an investment-blind basis, meaning that ReFlow will stand ready to purchase and redeem shares of Participating Funds without regard to their investment objectives or performance. ReFlow expects a broad range of mutual funds to participate in the Auction Program, and all mutual funds will be eligible to become Participating Funds. However, only those funds in which ReFlow is eligible to invest without the imposition of a sales charge or transaction or redemption fee will be eligible to become Participating Funds. All Participating Funds must also determine their net asset values as of the close of business on the New York Stock Exchange (generally 4:00 p.m., Eastern time) ("Market Close"). In addition, ReFlow will exclude a fund that is, or during the previous 12 months has been, subject to certain regulatory enforcement actions, or that cannot represent to ReFlow that it is in compliance with certain legal and regulatory requirements applicable to open-end management investment companies.

Participating Funds would need to determine that the services provided by ReFlow under the Auction Program were sufficiently valuable to justify the expense involved in acquiring them. As such, Participating Funds would be engaged in an exercise comparable to the exercise in which they engage when they evaluate the value of services provided by any potential service provider to the funds, such as a custodian, accountant, transfer agent, or

shareholder servicing agent. Any of these entities may also be a fund shareholder independently of any service arrangement existing between the fund and the service provider. As long as the fees paid under the relevant arrangement are *bona fide* and proportionate to the value of the services provided to the Participating Fund, we believe that no provision of the 1940 Act would prevent the payment of such fees, even if the service provider/shareholder were an "affiliate" of the fund.²

Description of Auction Program

As long as ReFlow has capital available in excess of a small reserve, ReFlow will hold a daily auction in which it will, as described below, make available cash to purchase shares of Participating Funds. This auction will occur each business day, unless cancelled by ReFlow prior to the Market Close, or unless mechanical difficulties or other extraordinary conditions make it impossible to conduct the auction.³ ReFlow anticipates establishing a secure, password protected internet site through which it will conduct the auctions.⁴ At the beginning of each business day, ReFlow will announce the terms of that day's auction on its website, including: how much money it initially has available to purchase shares from Participating Funds (the "Initial Auction Amount"); the minimum dollar amounts for which Participating Funds may bid; and the minimum fee that ReFlow will accept from a fund bidding in the auction.

As of the close of business of each fund business day, every mutual fund typically can determine whether there have been net purchases (more shares purchased than redeemed) or net redemptions (more shares redeemed than purchased) that day. Prior to Market Close, Participating Funds that wish to take part in that day's auction will place bids into the ReFlow Auction Program, each of which will constitute an offer to pay ReFlow a fee calculated as a fixed percentage of the net asset value ("NAV") of the fund's shares purchased by ReFlow on the date the shares are purchased. Bids will consist of two components: 1) the amount of liquidity the fund desires; and 2) the maximum fee, expressed in basis points, that the fund is willing to pay. Funds can express the amount of liquidity they wish to bid for either as a percentage of the fund's daily net redemptions (a "standing bid"), or by a specific dollar amount (a "cash bid").⁵ Participating Funds cannot obtain more liquidity than would bring their net redemptions to zero. Bids may be modified or cancelled by a Participating Fund on a particular day up until the Market Close.

All purchases and redemptions of fund shares by ReFlow will be deemed to have been effected as of the Market Close. However, in order to calculate auction results, ReFlow needs to receive information from the Participating Funds that will not be available until after Market Close. This information includes each Participating Fund's net purchases or redemptions for that day, the number of the fund's outstanding voting securities, and the fund's NAV. However, for many Participating Funds, final information with respect to net purchase or redemption activity may not be available until the following morning. This is due to purchase and redemption orders received by third-party financial intermediaries prior to Market Close, but transmitted to the Participating Fund later.⁶ Accordingly, results of the ReFlow Auction will be disclosed early on the next business day, as near as practicable to market opening at 9:30 a.m. Eastern Time, and Participating Funds will be contractually obligated to report the required information to

ReFlow before that time.⁷

The Auction Program runs on a computer software program, and is completely automated. Neither ReFlow nor any Participating Fund can influence the outcome of the Auction after the Market Close. Once all reports are received from the Participating Funds, the first step of the Auction Program will be to determine which Participating Funds in which ReFlow currently owns fund shares had net purchases. Shares owned by ReFlow of each Participating Fund that had net purchases will be redeemed at the NAV of the fund calculated as of the Market Close, in an amount equal to the lesser of: 1) the net number of shares sold by the fund; or 2) the number of shares owned by ReFlow. The Auction Program will issue a redemption order to the fund automatically, without any action to be taken by ReFlow, and without any discretion on ReFlow's part. ReFlow will be contractually obligated to redeem these shares under the terms of its agreement with the Participating Funds, unless ReFlow issues a notice suspending all such automatic redemptions prior to Market Close. ReFlow anticipates that it will rarely, if ever, suspend automatic redemptions.⁸ Participating Funds will redeem shares held by ReFlow in the same manner that they will redeem shares held by other shareholders.

Based on the automatic redemptions, the Auction Program will calculate the additional amount of cash to be received by ReFlow. This amount will automatically be added to the Initial Auction Amount.⁹ This combined amount, minus a small cash reserve for error corrections described below, will be the amount available for the auction (the "Final Auction Amount").

Once the Final Auction Amount is determined, the auction will be conducted for those Participating Funds taking part in that day's auction that experienced net redemptions. First, for any fund that placed a standing bid for a certain percentage of its net redemptions, the Auction Program will calculate the dollar amount of that fund's bid based on the net redemptions reported.¹⁰ For any fund that placed a cash bid but thereafter reported net redemptions of less than that amount, the fund's bid would be reduced to the amount of its net redemptions.¹¹ Once all bids have been reduced to a specific dollar amount, the auction will take place. The auction will be a "Dutch auction," in which the fee rate charged to all successful bidders would be the lowest fee rate bid at which the entire Final Auction Amount could be invested.¹²

Additionally, in determining which funds are successful in the auction ("Winning Funds"), the Auction Program will use each Winning Fund's NAV and the dollar amount of the fund's winnings to calculate the number of shares that it would have to purchase of each Winning Fund. Under Section 12(d)(1) of the 1940 Act, ReFlow will be prohibited from acquiring more than 3% of the total outstanding voting stock of any Winning Fund. Accordingly, if the number of shares ReFlow would be required to purchase of any Winning Fund, plus any shares already owned by ReFlow, would exceed more than 3% of the outstanding voting securities as reported by the fund, ReFlow will not purchase those shares.¹³ Rather, ReFlow will only purchase an amount up to 3% of the outstanding voting securities of the fund, and the remaining cash would be available for other Winning Funds in the auction.¹⁴

Once the auction results have been calculated following the reporting

deadline, ReFlow will notify each Participating Fund that took part in the auction whether it is a Winning Fund, how much the fund has won, and the winning fee rate bid in basis points. The Auction Program will automatically issue a purchase order to each Winning Fund in the amount the fund has won, which will be effected by the fund at the NAV of the fund determined as of the prior day's Market Close. At the same time, ReFlow will issue any automatic redemptions for those funds that experienced net sales on the prior day, as discussed above. Unless ReFlow takes the unexpected step of redeeming shares on its own initiative, all purchase and redemption orders by ReFlow to the funds will happen automatically, without any action to be taken by ReFlow, and without any discretion on ReFlow's part. ReFlow will be contractually obligated to purchase or redeem fund shares under the terms of its agreements with the Participating Funds.

Neither ReFlow nor any bidding fund will have any power to affect any fee rate bid, the amount of cash bid for, or the Final Auction Amount, after the Market Close. While the amount of cash bid for by each fund and the Final Auction Amount cannot be determined until after Market Close, ReFlow has no control over these amounts. The Final Auction Amount depends solely on the reported purchase and redemption orders of all other shareholders of the Participating Funds, whose orders must be received by those funds or their designees prior to Market Close. In addition, all information reported by Participating Funds will be submitted on ReFlow's secure, password-protected website. Thus, before any given auction, typically no one at ReFlow will know which Participating Funds have had net redemptions, which Participating Funds have entered that day's auction, or which funds will be successful in the auction.¹¹ ReFlow will not purchase shares of any fund that is a Participating Fund outside of the Auction Program. ReFlow may, however, purchase shares of non-participating funds at any time for cash management or other purposes.

ReFlow anticipates that there may be limited instances in which a Participating Fund inadvertently reports inaccurate information about its net purchase or redemption activity, or reports its information after the auction deadline. This could occur as a result of inaccurate data provided by third-party financial intermediaries, or the fund's transfer agent, or because of other technological or human error. To deal with this possibility, ReFlow intends to set aside a small cash reserve equal to one half of one percent of the Final Auction Amount.¹² If a Participating Fund discovers after the auction that it has made a reporting error, or if a Participating Fund does not report its information by the auction deadline, it will be contractually obligated to report its corrected information to ReFlow immediately. If the fund was a Winning Fund, and experienced more net redemptions than previously reported, ReFlow will automatically issue another purchase order to the fund for the amount of the error, at the winning fee rate determined in the auction, up to the amount of the cash reserve.¹³ Conversely, if the fund was a Winning Fund and experienced less net redemptions than previously reported, or if such report is made after the auction deadline, ReFlow will automatically issue a redemption order to the fund in the amount of the error.¹⁴ Finally, if ReFlow owned shares of a Participating Fund that experienced net sales (thus necessitating an automatic redemption request from ReFlow, as described above), and those net sales were in fact more than previously reported, ReFlow will automatically issue an additional redemption order to the fund in the amount of the error. Any amounts received from automatic redemptions that result from error corrections would be added to the cash reserve for that day. Error

corrections will be available to funds on a first come, first served basis, until the cash reserve runs out, and will be accepted up until Market Close that day.

Error corrections have no effect on other Participating Funds. Auction results are final for those Winning Funds that have filed accurate reports. As with the auction itself, all purchase and redemption orders by ReFlow resulting from error corrections will happen automatically, at the NAV of the fund determined after the prior day's Market Close, without any action to be taken by ReFlow, and without any discretion on ReFlow's part. ReFlow will be contractually obligated to purchase and redeem fund shares consistent with these error correction policies, which will be set forth in ReFlow's agreements with the Participating Funds.

As compensation for providing the Participating Funds with an alternative source of liquidity and a means to offset, in whole or in part, a Winning Fund's net redemptions, ReFlow will receive a fee equal to the winning fee rate bid in the auction. The fee will be calculated as a fixed percentage of the net asset value of the Winning Fund's shares purchased by ReFlow on the date the shares are purchased.¹⁹ The fee will not vary depending upon the length of time ReFlow holds the shares. No additional fee would be paid to ReFlow.

To make the Auction Program an attractive alternative to other means of addressing the consequences to a fund of being in a net redemption posture, the fee payable under the Program to ReFlow is expected to be influenced by the comparative availability and cost of current short-term lending arrangements that Participating Funds may have with lenders, and the comparative costs to the fund and its shareholders of selling portfolio securities to meet redemptions. Because ReFlow will be an equity owner of Winning Fund shares in the interim, ReFlow will participate in increases or decreases in the price of such shares over the course of any period during which it holds fund shares.²⁰

Industry experience suggests that, on average, mutual funds typically experience net redemptions for a period of five days to two weeks before returning to a state of net sales. As such, ReFlow normally expects that it would hold shares of a Winning Fund for no longer than a few days or weeks. ReFlow does not expect to redeem shares outside of the automatic redemption procedures of the Auction Program. ReFlow has the right to redeem shares at any time in the same manner as any other shareholder. As a business matter, however, ReFlow would prefer not to redeem fund shares on its own initiative.

Discussion and Legal Analysis

We are aware that these proposed transactions may raise concerns under Rule 22c-1 and Rule 12b-1 under the Act and Section 22(d) and Section 18 (f) of the Act.

Rule 22c-1

The method through which ReFlow would be purchasing or redeeming its shares of Winning Funds may raise a question under Rule 22c-1 under the Act, which requires that mutual funds, such as the Winning Funds, issuing

redeemable securities not

sell, redeem, or repurchase any such security except at a price based on the then current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security.

Specifically, we believe that both the purchase of shares of a Winning Fund and the redemption of ReFlow's position in a Winning Fund find close parallels in the automatic share exchange program offered by the Capital Preservation Fund, Inc.²¹ Under the automatic share exchange program described in that no-action letter, shareholders were able to place advance orders to buy or sell mutual fund shares at prices which were predetermined by the shareholder. Shares of a non-money market fund would be purchased automatically by an exchange from a money market account once the shares of the non-money market fund fell to a predetermined price, or shares of a non-money market fund would be sold automatically to purchase money market shares by exchange once the shares of the non-money market fund rose to a predetermined level. Because the contractual terms of the Auction Program specify when ReFlow must redeem its position in the shares of a Winning Fund (unless ReFlow issues a notice suspending automatic redemptions prior to Market Close), the redemption transaction should be treated like the advance order to sell shares of a fund was treated in the Capital Preservation Fund letter. Excluding the unexpected case in which ReFlow redeems shares on its own initiative, or pursuant to another automatic redemption policy, on any given day when there are net purchases of fund shares, ReFlow would redeem only an amount of shares which would cause the fund to be in a neutral state; in other words, ReFlow generally would only redeem shares to the extent that any such redemption when taken together with the net purchases of the fund shares for that day would cause the fund to be neither in a state of net sales nor net redemptions.²²

Similarly, whether ReFlow will be required to purchase shares of a particular fund will be determined effectively at Market Close on any given day, even though the results of that determination cannot be definitively known until the following morning. Funds that have net redemptions that have participated in that day's auction and that have submitted bids which win in the auction will then become Winning Funds. The factors that determine whether a fund will be a Winning Fund (*i.e.*, the Final Auction Amount, the fund's fee bid and its purchase and redemption activity for that day), and thus whether ReFlow will purchase or redeem shares of the fund as of that day, are automatically and *unalterably* determined as of Market Close on that day, even though the reporting by funds and processing through ReFlow's software and notification to the Winning Funds will occur later.

We believe no-action treatment is appropriate for the Auction Program because it would be consistent with the purposes and administrative history of Rule 22c-1.

One purpose of Rule 22c-1 is to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies

through (i) the sale of such securities at a price below their net asset value or (ii) the redemption or repurchase of such securities at a price above their net asset value. Dilution through the sale of redeemable securities at a price below their net asset value may occur, for example, through the practice of selling securities for a certain period of time at a price based upon a previously established net asset value. This practice permits a potential investor to take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase. An investor may be encouraged to purchase securities in this manner by the practice of announcing the next sale price in advance of the time at which it becomes effective, thereby enabling the investor to time his purchase so as to obtain investment company securities at the lower of two known prices.... [S]uch practices have the effect of diluting the value of outstanding redeemable securities of registered investment companies.

Another purpose of Rule 22c-1 is to eliminate or reduce so far as reasonably practicable other results, aside from dilution, which arise from the sale, redemption, or repurchase of securities of registered investment companies and which are unfair to the holders of such outstanding securities. The Commission believes that the practice of selling securities for a certain period of time, at a price based upon a previously established net asset value, encourages speculative trading practices which so compromise registered investment companies as to be unfair to the holders of their outstanding securities. This pricing practice allows speculators to buy large blocks of such securities under circumstances where the net asset value of the securities has increased, but where the increase in value is not reflected in the price. The speculators hold such securities until the next net asset value is determined and then redeem them at large profits. These speculative trading practices can seriously interfere with the management of registered investment companies to the extent that (i) management may hesitate to invest what it believes to be speculators' money and (ii) management may have to effect untimely liquidations when speculators redeem their securities.... [S]uch practices cause unfair results to the holders of outstanding securities of registered investment companies.²¹

A Participating Fund may be engaged in backwards pricing because ReFlow's purchase and redemption orders will be effected at the Participating Fund's previously computed NAV. However, a Participating Fund cannot engage in unfair or speculative trading through backward pricing because it cannot take advantage of the previously computed NAV. Each Winning Fund is committed to selling shares to ReFlow at its NAV per share as of that day's Market Close. Participating Funds also cannot affect the timing or amount of shares to be redeemed by ReFlow. Similarly, ReFlow cannot take advantage of the previously computed NAV because it is contractually obligated to purchase or redeem shares based on factors determined as of Market Close. Thus, neither ReFlow nor the Participating Funds can engage in the type of dilutive pricing or speculative trading in a fund's shares envisioned by the Rule 22c-1 adopting release. On any given

auction day, ReFlow has no control over which funds will bid for capital and has no control over which funds will submit the winning bids just as ReFlow will have no control over which funds have positive sales and to which it will redeem shares.⁴⁴ ReFlow will also have no control over the Final Auction Amount after Market Close. ReFlow will be contractually obligated to purchase or redeem fund shares in accordance with the auction procedures described above. ReFlow and the Participating Funds therefore cannot effectively engage in any dilutive backwards pricing.

These facts are strikingly similar to the automatic purchase and redemption provisions that the staff approved in the *Capital Preservation* letter. The factors that will determine the identity of the Winning Funds of each daily Auction will effectively be determined at Market Close, and ReFlow will be contractually committed to purchase or redeem shares of each Winning Fund consistent with the terms of the Auction Program, regardless of whether the market appears to be on an upswing or a downswing.

Normally when a fund has net redemptions on any given day, the fund must (i) use existing cash balances to meet redemptions, (ii) borrow money to meet redemptions or (iii) sell portfolio securities to meet redemptions. As explained above, the purchases by ReFlow which offset what would otherwise be net redemptions allow a fund that would otherwise have to redeem portfolio securities, at possibly disadvantageous times or prices, to meet redemptions and keep all of its portfolio securities, thus benefiting the other shareholders. The sale of portfolio securities also causes additional trading costs and brokerage costs, which increases the fund's expenses, and can lead to the realization of capital gains, which may have adverse consequences for shareholders. If the fund does not have to sell the securities, these costs and consequences can be avoided. Each fund will, based on an analysis of its own circumstances, determine whether to participate in the auction process and any purchase order by ReFlow will arise from that determination not any decision by ReFlow to purchase shares of a fund. Accordingly, we believe ReFlow's purchase order stems from the fund's otherwise net redemption position and submission of a winning bid.

In sum, because the structure of the auction process prevents ReFlow from making speculative purchases of shares of the funds, and because the automatic redemption provisions of the Auction Program would prevent ReFlow from making unduly disruptive redemptions, the concerns raised in the adopting release for Rule 22c-1 are not present in this case.

Section 22(d)

As a preliminary matter, it bears emphasis that nothing in the text of Section 22(d) would make the Auction Program unlawful. Section 22(d) prohibits a fund from selling its shares at a price other than the current public offering price described in the fund's prospectus. Because the Participating Funds will either be no-load funds or load funds which have waived the load or any other transaction or redemption fees with respect to ReFlow (with the appropriate disclosure in their prospectuses), the current offering price of the shares of each Winning Fund, as described in their prospectuses, will be their net asset value. Thus, on its face, the Auction Program complies with Section 22(d). However, because ReFlow will receive a fee in connection with its provision of services under the Program, which

fees may be paid by a Winning Fund, it could be argued that the fee is an offset to the purchase price and the economic effect of the transaction is that ReFlow is purchasing shares of each Winning Fund at a price below net asset value. We believe, however, that fees paid under the Program are properly characterized as *bona fide* compensation for access to the ReFlow auction mechanism and short-term liquidity facility, and for ReFlow's ongoing liquidity management, recordkeeping, and administrative support services. Any Participating Fund will be able to determine whether the liquidity management and administrative services offered by ReFlow constitute a valuable service for which the fund is willing to pay a fee. As noted above, it is anticipated that, in evaluating the potential benefits offered by ReFlow, Participating Funds will compare the cost of participating in ReFlow with the cost implicit in other alternative methods of liquidity management, including the costs of establishing and maintaining short-term credit facilities. ReFlow believes that the services it provides will constitute a tangible, *bona fide* benefit to Participating Funds for which the fees charged will be appropriate. Any fund participating in the program that intended to pay fees directly would as a threshold matter have made the determination that participating in the ReFlow program is in the best interests of the fund and its shareholders and that fees paid under the program constitute a beneficial fund expense.

This service and the applicable fee are not different from other administrative and service fees and expenses paid by funds, including 12b-1 fees. In this regard, a shareholder who purchases shares in a non-12b-1 class of a fund that has multiple classes of shares and imposes 12b-1 fees on its other classes is not regarded as having purchased shares at less than net asset value, even though the economic effect is the same. Moreover, Section 22(d) has never prohibited service providers, including affiliates of the fund's investment adviser, from owning shares of the fund even though the service provider may earn fees attributable in some measure to the shares it owns (e.g., advisory fees, transfer agent fees, fund accounting fees, distribution fees).

ReFlow is not establishing the Auction Program in order to acquire fund shares at a discount. ReFlow's business model in establishing the program is to act as a service provider to funds, and to receive income in the form of auction fees. While ReFlow will be a shareholder of all Winning Funds, with the same rights and privileges as all other shareholders, investment in the Winning Funds is not ReFlow's primary goal. Unlike other investors, ReFlow does not discriminate among the Participating Funds based upon their investment objectives, policies, fees, performance, or any of the other things that investors typically factor into an investment decision. Rather, ReFlow makes the Auction Program available to all eligible funds on an investment-blind basis, meaning that ReFlow will not exercise any discretion in deciding whether to purchase or redeem Participating Fund shares. ReFlow will purchase or redeem shares automatically pursuant to the terms of the Auction Program. In addition, unlike many shareholders who may be long-term investors, ReFlow expects that it will only hold Winning Fund shares for a limited period of time, often as short as a few days. The investment by ReFlow in any particular Winning Fund is therefore only incidental to the Auction Program and the fee income ReFlow hopes to earn thereby. ReFlow is therefore not attempting to invest in Winning Fund shares at a price below net asset value.

We are aware that the Staff has, on numerous occasions, taken the position

that funds may offer financial benefits to certain fund shareholders and not others and not be deemed to have violated Section 22(d), as long as the benefit relates to an arrangement or transaction independent of the mere holding of fund shares. For example, the Staff has granted no-action relief under Section 22(d) with respect to the offer of certain discounts provided in connection with the purchase of fund shares when: (1) the discounted transaction was separate from the purchase of fund shares; or (2) the discount represented a reduction in a *bona fide* fee otherwise payable by the client for services provided by a distributor or its affiliates.²⁵

The situations addressed by the Staff in these letters generally have involved a reduction in a fee payable by a shareholder for services provided by the fund's distributor or an affiliate.²⁶ In contrast, the Auction Program involves the payment of a fee by a fund for services provided by a fund shareholder. We believe, however, that the underlying rationale of these letters — that payment of a fee for a *bona fide* service should not be construed as a discount from the purchase price of fund shares — is equally applicable to the Auction Program. As noted above, fees paid under the Program are compensation for access to the ReFlow auction mechanism and short-term liquidity facility, and for ReFlow's ongoing liquidity management, recordkeeping, and administrative support services. The ReFlow program is readily analogous to a service arrangement with an entity that also happens to be a fund shareholder. We believe that the Auction Program raises even fewer Section 22(d) concerns than the fact patterns suggested in these no-action letters.

Section 18(f)

Section 18(g) of the Act defines "senior security" in part as "any stock of a class having priority over any other class as to distribution of assets or payment of dividends." In addition, Section 18(f)(1) of the Act provides, in relevant part, that

it shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer

As pointed out with respect to Section 22(d) above, there is nothing in the text of Section 18(f) which suggests that the shares purchased by ReFlow should be regarded as "senior securities" as a result of the fees received by ReFlow from the Winning Funds. We are aware, however, that the Staff has taken the position in other contexts that the provision of a specified benefit to one class of shares of a fund which is not available to the other classes of shares may result in the issuance of a senior security by the fund.

In the current case, ReFlow will receive no special benefits as a *shareholder* of any Winning Fund. That is, ReFlow will not be subject to special or differential treatment as a shareholder of any Winning Fund nor will ReFlow have any rights as a shareholder of a Winning Fund that would not be shared by all other fund shareholders. As noted above, ReFlow does differ from other shareholders in that its investment in a particular Winning Fund is not based upon traditional factors. ReFlow, however, is acting as a service provider to funds, and any benefit ReFlow receives from funds is in that capacity, not in its capacity as a shareholder. ReFlow would be entitled to a fee relating to a fund's participation in the Program, which may be

borne as an expense of a Winning Fund or may be borne as an expense of the Fund's investment adviser or distributor.²⁷ The Participating Funds, and their advisers and distributors, will not pay any fees to ReFlow outside the Auction Program. As noted above, the fee charged does not vary based on the length of time ReFlow holds shares and would be *bona fide* compensation to ReFlow for its provision of liquidity management and administrative services to Participating Funds. The fee would not represent compensation for investing in shares of any fund. Any Participating Fund authorizing the payment of such fees to ReFlow would have been required as a condition to participating in the Program to have made this determination independently. Therefore, we do not believe that payment of fees to ReFlow raises the types of "fairness" concerns that have been cited by the Staff in other no-action letters involving Section 18(f).²⁸

Moreover, we do not believe that the ReFlow program raises leveraging concerns of a type that have been raised in other contexts in connection with concerns about Section 18(f). First, we believe that there simply is no "leveraging" in the sense that the only obligation placed on the Participating Funds is to redeem their shares held by ReFlow at net asset value, just as they stand ready to do for any other shareholder. Shares purchased by ReFlow do not represent a liability to the Winning Fund, as would a borrowing, but are more properly considered to be the sale of an equity interest in the fund. Furthermore, to the extent that any argument could possibly be made that leveraging exists, we note that the Staff has allowed funds to enter into securities lending transactions, options, futures, options on futures, short sales, spreads, straddles, reverse repurchase agreements, standby commitments, firm commitments, and other types of transactions which would have the effect of leveraging a fund.²⁹ These types of activities have been permitted where measures have been taken to protect fund investors, i.e., where cash or other highly liquid assets have been segregated in an amount sufficient to cover the "borrowing", even though the holders of the putative senior securities or their successors might receive the functional equivalent of a priority in the distribution of assets. Presumably, the Staff concluded that the risks of these leveraging transactions, including actual loss of fund assets, were outweighed by the benefit to all of the fund's shareholders through an increase in the fund's rate of return.

Our situation involves far less shareholder protection concerns than arise from leveraging. To the extent our situation is analogous to those summarized above, any slight "dilution" of shareholder interests (assuming one characterizes the payment of fees as a "dilution" of shareholder interests) would be outweighed by the service provided by ReFlow and the benefits to all shareholders accruing through the use of the Auction Program.³⁰

We do not believe that there is any policy underlying Section 18(f) which would be promoted or protected by an interpretation that participation in the Auction Program involved the issuance of a senior security. In sum, we do not believe that it is necessary or appropriate to interpret Section 18(f) to apply to the Auction Program.

Rule 12b-1

Rule 12b-1 under the 1940 Act makes it unlawful for a fund to act as a

distributor of its own shares, except through an underwriter, unless the fund follows the conditions set forth in the rule. For purposes of the rule, a fund is deemed to be acting as a distributor if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of its shares. It could be argued that because a Winning Fund may pay the auction fee at the time it sells shares to ReFlow, the fund is paying for the distribution of its shares, and that the auction fee must therefore be paid pursuant to a plan adopted under Rule 12b-1. We believe, however, that payment of the auction fee by a Winning Fund should not be construed as payment for distribution of fund shares.

ReFlow will purchase and redeem shares of Participating Funds pursuant to the terms of the Auction Program. Participation in an auction by a Winning Fund would not result in the net sale of any fund shares, because ReFlow would only purchase an amount of shares equal to the Winning Fund's net redemptions. Any subsequent net sales by the Winning Fund would be immediately offset by redemption of a corresponding amount of shares held by ReFlow. Participation in the Auction Program therefore would not assist a fund in the distribution of its shares, and funds would not participate in the Auction Program with the primary intent of distributing their shares. Rather, the primary intent of the funds is to meet their short-term liquidity needs at a lower cost than borrowing money or liquidating portfolio securities. The sale of fund shares is merely incidental to that legitimate purpose. We note that the Commission has stated that whether or not any particular payments are for distribution is a question of fact to be decided by a fund's board of directors.³¹ We believe that the board of directors of a fund could reasonably conclude that payment of the auction fee by the fund is not for distribution. As noted above, each Participating Fund will provide a copy of a resolution of its board of directors authorizing the fund to participate in the Auction Program so long as the fund promptly uses any auction proceeds only for redemption purposes.

In addition, we believe that requiring funds to pay the auction fee pursuant to a 12b-1 plan would not serve the purpose the rule was designed to address. First, it bears noting that the types of fees traditionally paid for out of 12b-1 plans (e.g., advertising, printing and mailing prospectuses, compensation to underwriters, broker-dealers, etc.), are qualitatively different than the fees to be paid by the Winning Funds. Second, Rule 12b-1 was designed to address the potential conflicts between a fund and its investment adviser that are created when a fund bears its own distribution costs. When a fund bears these expenses, the fund's investment adviser is spared from paying these costs itself. In contrast, an investment adviser has no direct obligation or interest in paying for a fund's short-term liquidity needs. If, for example, funds were required to pay the auction fee pursuant to a 12b-1 plan, and a fund that had not adopted such a plan was unable to participate in the Auction Program, the costs of otherwise meeting its short-term liquidity needs (e.g., borrowing money or liquidating portfolio securities), would be borne by the fund, not its investment adviser. Therefore, payment of the auction fee by a fund does not present the kind of conflict of interest between a fund and its investment adviser that is raised by traditional marketing or distribution expenses.

* * * *

We hereby request that the Staff of the Division of Investment Management advise that it would not recommend that the Commission take any

enforcement action for violation of Rule 22c-1 or Rule 12b-1 or Sections 22 (d) and 18(f) if ReFlow and the Participating Funds were to engage in the transactions described above. If you have any questions, please contact me at (202) 261-3356 or Brendan C. Fox at (202) 261-3381.

Sincerely,

Robert W. Helm

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Endnotes

¹ Thus, for example, if ReFlow owned 40 shares of a fund and the fund sold 30 shares, ReFlow would redeem 30 shares and would retain the other ten. If the fund experienced further net sales of at least ten shares on a later day, and ReFlow had not already redeemed them on its own initiative or pursuant to another automatic redemption policy (see note 9 *infra*), ReFlow would then redeem its final ten shares. As noted below, because the shares purchased by ReFlow are "redeemable securities" as defined in Section 2(a) (32) of the 1940 Act, ReFlow could seek to redeem them at any time, although as a business matter it may voluntarily determine not to do so.

² Section 17(d) of the 1940 Act and Rule 17d-1 thereunder have been interpreted to govern the establishment of "service arrangements" between funds and their "affiliated persons." In general, assuming that a proposed service arrangement with an affiliate satisfies tests that it is necessary for the operations of the fund and will be entered into on terms at least as favorable as those applicable to similar arrangements with non-affiliates, we believe such arrangements will not be deemed to conflict with Section 17(d) under the 1940 Act (see, e.g., *Merrill Lynch Capital Fund, Inc.* (pub. avail. Dec. 21, 1990); *Washington Square Cash Fund* (pub. avail. July 9, 1990); *Unified Growth Fund*, (pub. avail. June 28, 1990); *The Flex Fund* (pub. avail. Nov. 22, 1985); *Federated Securities Corporation* (pub. avail. Oct. 21, 1983)), nor do we believe that such service arrangements involve the issuance of "senior securities" by a fund. We are not requesting any no-action relief from the staff with respect to Section 17(d) and Rule 17d-1 thereunder.

³ "Extraordinary conditions" would be defined in any agreement between ReFlow and the Participating Funds and would be limited to events of *force majeure* (i.e., events beyond the control of ReFlow which make it impossible for ReFlow to conduct the auction).

⁴ ReFlow has contracted with various vendors for the development, installation, maintenance and upgrading of the software used to conduct the daily auctions. Participating Funds will be in daily contact with ReFlow concerning their liquidity needs and liquidity management concerns. ReFlow will provide 24 hour customer service to ensure continued connection to the platform server, maintain the integrity of the service site, and report program results to Participating Funds. Reports provided by ReFlow on a daily basis will include reports on the daily auction parameters (containing minimum initial auction amounts; minimum fee bids; minimum cash amount and subsequent increments; limits on the percentage of fund shares that ReFlow may legally own; and annual trading day calendar);

reports on daily sales (containing information on the last auction amount; lowest winning fee; unused limit and minimum fee bid; ability to default to standing bid or updated one day bid and bid confirmation); voluntary redemption report (showing the current ReFlow holdings); and a client report for each Participating Fund (showing net asset value per share, flow excluding ReFlow trades, and fund net asset value excluding ReFlow trades). Reports provided by ReFlow will ensure that there is full and complete sharing of information between ReFlow and any Participating Fund on a real time basis.

² For example, if a Participating Fund desired ReFlow to purchase an amount of shares that would reduce the net redemptions of the fund, after those purchases, to zero, the fund would submit a standing bid of 100%, along with the amount of basis points that it would be willing to pay. Similarly, if the fund wanted to reduce its net redemptions by half, it would bid 50%. Standing bids remain in effect from day to day unless changed or cancelled. Cash bids, on the other hand, are effective only for one day. ReFlow anticipates that most funds will enter a standing bid for 100% of their net redemptions. However, in order to provide funds with maximum flexibility in meeting their liquidity needs, ReFlow will permit Participating Funds to make cash bids, or standing bids for up to 100% of their net redemptions.

³ For example, funds may have relationships with broker-dealers or other financial intermediaries that are designated to receive purchase and redemption orders on behalf of the fund, and which are deemed received by the fund when received by the designee, but not reported to the fund until after Market Close. See e.g., *Charles Schwab & Co.*, (pub. avail. July 7, 1997).

⁴ The reporting deadline may be later than 9:30 a.m., Eastern time, (but no later than 10:30 a.m. Eastern time) if ReFlow provides notice of the changed deadline on its website by Market Close on the prior business day. In the unlikely event that a fund has failed to report by the morning deadline, it will be deemed to have reported zero purchases or sales for purposes of determining the auction results. The Fund remains contractually obligated to report as soon as possible thereafter. When it does, its report will be treated as an error correction report, discussed at notes 16-18 *infra* and the accompanying text.

⁵ ReFlow may adopt other automatic redemption procedures. For example, ReFlow may adopt a procedure to automatically redeem shares which have been held for a maximum stated period, regardless of whether a Participating Fund remains in a state of net redemptions. Any automatic redemption procedure will be disclosed on ReFlow's website, will apply uniformly to all Participating Funds, and any change to a procedure will only apply prospectively. ReFlow will be contractually obligated to redeem shares in accordance with any automatic redemption procedure. We are not requesting the staff's views with respect to any such automatic redemption procedures.

⁶ A Participating Fund that has net redemptions, and in which ReFlow has invested, may nonetheless determine that it no longer wishes to participate in the ReFlow program. In this event, a Participating Fund may request that ReFlow redeem its shares ("Voluntary Redemptions"). ReFlow would not be

required to redeem its shares upon such a request, although as a business matter it may voluntarily determine to do so. All Voluntary Redemption requests must be received prior to Market Close. All cash due to ReFlow from Voluntary Redemptions will be added to the Initial Auction Amount.

¹⁰ For example, if a fund had placed a standing bid for 75% of its net redemptions and then reported \$100,000 in net redemptions, the Auction Program would calculate that fund's bid to be for \$75,000.

¹¹ For example, if a fund had placed a cash bid for \$100,000 and then reported \$75,000 in net redemptions, the Auction Program would treat it as a bid for \$75,000.

¹² Suppose, for example, that the Final Auction Amount is one million dollars. Fund A bids 90 basis points, which proves to be the highest fee rate bid, for \$200,000. Fund B, the second highest fee rate bidder, bids for \$300,000 at 80 basis points. The next-highest fee rate bids are 65 basis points for \$75,000 by Fund C, 45 basis points for \$125,000 by Fund D, and 39 basis points for \$600,000 by Fund E. The outcome is that Funds A through D receive all the cash they bid for at a fee rate of 39 basis points. Since they have collectively won \$700,000, only \$300,000 remains for Fund E. Thus Fund E wins \$300,000 at a fee rate of 39 basis points.

¹³ We note that Section 12(d)(1) will prevent ReFlow from *acquiring* more than 3% of the outstanding voting securities of a Participating Fund. If ReFlow becomes the owner of more than 3% of the outstanding voting securities due to redemptions by other shareholders, ReFlow will not be required to dispose of any shares, but will not be permitted to purchase any additional shares of that fund until such time as it owns less than 3% of the fund's securities.

¹⁴ For example, under the facts described in note 12 *supra*, suppose that ReFlow already held a substantial number of shares of Fund A, and that purchasing more than \$100,000 of Fund A shares would cause ReFlow to acquire more than 3% of its outstanding voting securities. In that case, although Fund A successfully bid for \$200,000, ReFlow would only purchase \$100,000 worth of Fund A shares, and the excess \$100,000 would be available for other Winning Funds (*i.e.*, Fund E would now win \$400,000).

¹⁵ If there were a systems failure, for example, if there were technical problems with ReFlow's website, it might be necessary for ReFlow's customer representatives to manually input fund reports into the Auction Program. However, as noted, these individuals would have no control over the outcome of the auction.

¹⁶ ReFlow expects that less than one percent of participating funds would submit error corrections on any given day, and that the aggregate amount of these corrections would be no more than one percent in either direction. Since the product of these fractions is one hundredth of a percent, ReFlow expects that a reserve of one half a percent should prove ample. Nonetheless, ReFlow reserves the right to revise this percentage amount upward, so long as any such change for a particular auction is made and disclosed to participating funds prior to Market Close.

¹⁷ In the case of a late reporting fund with net redemptions, if the fund's fee bid was equal to or greater than the winning bid in the auction, the fund will be considered a Winning Fund for purposes of the error correction procedures, and ReFlow will issue an automatic purchase order for the fund's shares in an amount equal to the lesser of the fund's liquidity request or the amount of the cash reserve.

¹⁸ For example, under the facts described in note 12 *supra*, ReFlow would maintain a cash reserve of \$5,000 (.5% of \$1 million). Suppose that Fund B discovered after the auction that due to a clerical error, it actually had net redemptions of \$301,000, rather than the \$300,000 reported. ReFlow would automatically issue another purchase order for \$1,000 worth of Fund B shares (subject to the limits of Section 12(d)(1) discussed above). Conversely, if Fund B discovered it only had \$299,000 in net redemptions, ReFlow would automatically issue a redemption order for \$1,000 of Fund B shares, and such amount would be added to the cash reserve.

¹⁹ We believe that this fee, if paid by a participating fund, should be deductible by the fund from fund investment income as a fund expense. ReFlow would in turn treat fees received by it pursuant to the Program as ordinary income for federal income tax purposes. The fee owed to ReFlow may be billed to funds on a monthly or other periodic basis, or may be deducted from auction winnings or added to redemption proceeds.

²⁰ ReFlow would realize capital gain or loss upon the redemption of shares of a participating fund held by it equal to the difference between the price at which it purchases the shares and the price at which the shares were redeemed, each of which would be equal to the then-current net asset value per share.

²¹ *Capital Preservation Fund, Inc.* (pub. avail. Sept. 11, 1990).

²² The Commission staff has issued no-action letters in other situations in which a proposed transaction did not comply literally with the provisions of the Rule, and did not involve any dilution or other unfairness. See *e.g.*, *CBA Money Fund, et al.* (pub. avail. June 9, 1994) (customer requests for same day settlement treated as redemption on basis of prior business day's share price); *Templeton Global Fund, Inc.* (pub. avail. Sept. 7, 1982) (purchase orders held in suspense account for up to 10 days when shares not available for sale, shares priced at next price determined after acceptance of order); *Scudder Tax Free Money Fund* (pub. avail. July 16, 1982) (orders consummated on day after receipt to allow fund to acquire federal funds); *Scudder Fund Distributors, Inc.* (pub. avail. Feb. 18, 1976) (net asset value next determined after receipt of check rather than order); *American General Exchange Fund* (pub. avail. Aug. 13, 1976) (fund shares exchanged for securities deposited by investors valued on Monday based on previous Friday's price). *Cf.* *Dreyfus Index Fund* (pub. avail. Sept. 21, 1987) (refusal to grant no-action request for purchase orders received between 12:00 noon and 4:00 p.m. proposed to be invested at next day's price rather than same day's price at close of New York Stock Exchange).

²³ Investment Company Act Release No. 5519, (Oct. 16, 1968). See also Investment Company Act Release No. 5413 (June 25, 1968) (proposing rule); Investment Company Act Release No. 13183 (Apr. 22, 1983) (proposal to adopt Rule 22d-1); and Investment Company Act Release No.

14244 (Nov. 21, 1984) (proposal to adopt amendment to Rule 22c-1 concerning time of day of pricing).

²⁴ As noted above, ReFlow does not expect to redeem shares outside of the automatic redemption procedures of the Auction Program. ReFlow, however, has the right to redeem shares at any time, although as a business matter it may voluntarily determine not to do so.

²⁵ See *Portico Funds, Inc.* (pub. avail. Apr. 11, 1996) (discounted banking services in connection with minimum mutual fund account balances).

²⁶ See *Id.*, *American Municipal Securities* (pub. avail. June 28, 1988) (reduced brokerage commissions for sales of stock reinvested in mutual fund shares), *Coleman Financial Services, Inc.* (pub. avail. Apr. 17, 1987) (same), *Stratford Advisory Group, Inc.* (pub. avail. Aug. 5, 1988) (advisory fee reduced by amount of mutual fund sales charges paid), *PolyComp Financial Group* (pub. avail. Aug. 12, 1985) (same), *Kelly, Duva, Pendell, Warschauer & Covey* (pub. avail. Apr. 24, 1985) (same), *Interfinancial Corporation* (pub. avail. Nov. 18, 1985) (same).

²⁷ We are not requesting any no-action relief from the staff with respect to any payment of the fee by a fund's investment adviser or distributor. Participating Funds, their investment advisers and distributors will not pay any fees to ReFlow outside of the Auction Program.

²⁸ See, e.g. *Neuberger and Berman Genesis Fund, Inc.* (pub. avail. September 27, 1988) (regarding the imposition of a "variable redemption price adjustment" (or discount) of 2% on redemptions of shares made within one year of purchase, with an exception for shares acquired through dividend reinvestment).

²⁹ See, e.g., *State Street Bank and Trust Co.* (pub. avail. Jan. 29, 1972) (securities lending); *Bartlett Capital Trust* (pub. avail. Aug. 19, 1985) (options, futures contracts and options on futures contracts); *Dreyfus Strategic Investing* (pub. avail. June 22, 1987) (short sales, purchasing and selling futures contracts, selling options on securities, selling options on stock indices, selling interest rate futures contracts, and purchasing and selling currencies on a forward basis); *Hutton Options Trading L.P.* (pub. avail. Feb. 2, 1989) (spreads); *Sanford C. Bernstein Fund Inc.* (pub. avail. June 25, 1990) (straddles); *Investment Company Act Release No. 10666* (Apr. 18, 1979) (reverse repurchase agreements, standby commitments and firm commitments); and *Investment Company Act Release No. 7221* (June 9, 1972). In addition, when the Commission adopted Rule 18f-1, it allowed funds to elect to pay redemptions of up to \$250,000 or up to 1% of the fund's net assets over a 90-day period in cash while paying redemptions of more than \$250,000 or more than 1% of the fund's net assets over a 90-day period in kind even though the result is that shareholders who receive cash receive what could be considered a senior security. *Investment Company Act Release No. 6561* (June 14, 1971). In other words, the Commission adopted a Rule that allows a fund to give priority as to the distribution of assets where there is no offsetting benefit to the shareholders who do not have priority.

³⁰ Threshold questions may be presented (1) under Section 18(f) by the fact that the automatic and Fund-determined redemptions may be

perceived as placing ReFlow in the position of having priority over the other common shareholders as to "distribution of assets" of the Winning Fund within the meaning of Section 18(g); and (2) under Section 22(e), because those redemptions might impair ReFlow's ability freely to redeem Fund shares at times of its choosing.

We do not believe that the redemption provisions would create senior securities, because a redemption by ReFlow would be no different from a redemption by any other Fund shareholder. That is, any other fund shareholder could redeem its shares at will on the same day as a redemption by ReFlow. In this connection, as discussed above, the Staff has not objected to automatic redemptions under other circumstances. See, e.g., the *Capital Preservation* letter, *supra* note 21.

With respect to Section 22(e), the staff has not objected to automatic redemptions of shareholder accounts falling below a specified dollar value, subject to certain conditions. *Research Capital Fund, Inc.* (pub. avail. Oct. 9, 1974.) See also, *Letter from Allan S. Mostoff, Director, Division of Investment Management Regulation, to Robert L. Augenblick, President of the Investment Company Institute ("ICI")* (pub. avail. Mar. 13, 1974); *DFA Large Cap Portfolio, Inc.* (pub. avail. Sept. 7, 1990). In this connection, we do not believe that the conditions imposed by the *Research Capital, ICI* and *DFA* letters would be appropriate here, because the redemption provisions in the Auction Program would not be imposed by a Winning Fund; they would be voluntarily accepted by ReFlow as a term of doing business. Therefore, ReFlow will not be waiving any of its rights as a shareholder or the protections of Section 22(e). We are not requesting any no-action relief from the staff with respect to Section 22(e).

²¹ See *Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies*, Release No. IC-16431 (June 13, 1988) at notes 129 and 173; see also *Letter from Douglas Scheidt, Associate Director of the Division of Investment Management to Craig S. Tyle, General Counsel of the Investment Company Institute* (pub. avail. Oct. 30, 1998).

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